

July 31, 2003

IN RE: DOCKET NO. 2002-367-C

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July 30, 2003

**VIA HAND DELIVERY**

Mr. Gary Walsh  
Executive Director  
South Carolina Public Service Commission  
101 Executive Center Drive  
Columbia, SC 29210



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Re: Generic Proceeding to Address the Definition of "Abuse of Market Position"  
Docket No. 2002-367-C

Dear Mr. Walsh:

Enclosed for filing are the original and twenty-five (25) copies of the Rebuttal Testimony of Dr. Brian K. Staihr in the above-captioned matter. Also enclosed is the Certificate of Service evidencing service on all parties of record.

I am enclosing an extra copy of Dr. Staihr's Rebuttal Testimony which I would ask you to date stamp and return to me by my courier.

If you have questions, please feel free to contact me.

Sincerely yours,

ELLIOTT & ELLIOTT, P.A.

  
SCOTT ELLIOTT

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## CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing Rebuttal Testimony of Dr. Brian K. Staihr in connection with the Generic Proceeding to Address the Definition of "Abuse of Market Position," Docket No. 2002-367-C upon all parties of record by depositing copies addressed to each as follows in the United States Mail, first-class postage prepaid.

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July 30, 2003.

ORIGINAL

UNITED TELEPHONE COMPANY OF THE CAROLINAS  
REBUTTAL TESTIMONY  
OF  
DR. BRIAN K. STAIHR  
BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA  
Docket No. 2002-367-C

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1 *Q. Please state your name, title, and business address.*

2  
3 A. My name is Brian K. Staihr. I am employed by Sprint Corporation as Senior  
4 Regulatory Economist in the Department of Law and External Affairs. My business  
5 address is 6450 Sprint Parkway, Overland Park, Kansas 66251.

6  
7 *Q. Are you the same Brian K. Staihr that filed direct testimony in this proceeding on*  
8 *July 23, 2003?*

9  
10 A. Yes I am.

11  
12 *Q. What is the purpose of your rebuttal testimony?*



1 A. In my rebuttal testimony I respond to various statements made by the other  
2 economists filing direct testimony in this proceeding. Specifically, I address statements  
3 made by Mr. Allen Buckalew (filing on behalf of the South Carolina Consumer  
4 Advocate) and Mr. Greg Darnell (filing on behalf of MCI-WorldCom). I also briefly  
5 discuss consistencies between my direct testimony and the direct testimonies of Dr.  
6 William Taylor (filing on behalf of BellSouth) and Mr. Dennis Trimble (filing on behalf  
7 of Verizon South Inc.).

8  
9 **MR. ALLEN BUCKALEW**

10  
11 *Q. On page 4 of Mr. Buckalew's testimony he writes, "Due to lack of competition in*  
12 *the market, if ILECs were unregulated (or improperly regulated) they would have a*  
13 *significant level of market power" (Buckalew Direct page 4). Do you agree with this*  
14 *claim?*

15  
16 A. No, because 1) the claim oversimplifies the conditions that lead to a firm having and  
17 being able to exercise market power, and 2) the claim oversimplifies the current state of  
18 competition in South Carolina.

19  
20 *Q. How does this claim oversimplify the conditions that lead to market power?*

21  
22 A. First, as discussed in detail in my direct testimony, it is not market power and  
23 competition that are mutually exclusive. Rather, it is market power and the textbook

1 concept of perfect competition that are mutually exclusive. As soon as we move away  
 2 from textbooks we find that real-world markets that exhibit effective competition also  
 3 exhibit market power. In some cases it is a small amount of market power, in other cases  
 4 it might be (to use Mr. Buckalew's term) "significant." And, again as stated in my direct  
 5 testimony, this is neither a problem nor undesirable.

6  
 7 Second, the ability of any firm to exercise any amount of market power depends on the  
 8 market price elasticity of demand for the good AND the price elasticity of supply of both  
 9 competitors and potential competitors. If a good has a demand that is price elastic, it  
 10 does not matter whether the good is provided by a single firm or a hundred competitors,  
 11 the ability of any firm to exercise market power will be limited. On the other hand, if a  
 12 good has a price elasticity of demand that is extremely inelastic then a market may  
 13 contain several providers, all competing with each other, but all having market power.

14  
 15 Third, a market may be served primarily by a single large provider with a cluster of  
 16 smaller providers making up what is called a "competitive fringe." If the price elasticity  
 17 of supply of these competitive providers is large (that is, a small increase in price will  
 18 cause them to supply more of the product to the market), then the large firm is extremely  
 19 limited in its ability to exercise market power.<sup>1</sup> In certain cases, the competitors need not  
 20 even be present in the market to control the exercise of market power. If entry into a  
 21 market is reasonably painless (in an economic sense) then the mere threat of potential  
 22 entry is enough to limit the ability to exercise market power.

23  


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<sup>1</sup> See Viscusi, Vernon and Harrington Jr., *Economics of Regulation and Antitrust*, MIT Press, 2000.



1 *How does Mr. Buckalew's claim oversimplify the current state of competition in South*  
2 *Carolina?*

3  
4 South Carolina, like almost every other state, has regions where competitive entry is  
5 more extensive and other areas where competitive entry is less extensive. Sprint's  
6 serving territory is no exception. In some regions we face facilities-based providers  
7 competing for our customers with attractive bundles that Sprint has difficulty matching.  
8 In other areas the competition may be more resale-based. But to simply assume there is a  
9 "lack of competition in the market," as Mr. Buckalew does in his testimony, is a mistake.  
10 In fact, competition has been particularly fierce for Sprint's business customers who are,  
11 on average, the lowest-cost customers to serve and often provide needed cross-subsidies  
12 to cover the costs of serving Sprint's more rural areas. In one particular Sprint exchange  
13 the loss of business lines to competitors exceeds 40%. Exacerbating the situation is the  
14 fact that some of these competitors are able to take advantage of low-interest federal  
15 funding from programs such as U.S.D.A.'s Rural Utilities Service (RUS) to finance their  
16 operations, funding that is not available to Sprint because of its size. In general, the  
17 competitive scenario in South Carolina is quite complex and should not simply be  
18 dismissed as non-existent, as Mr. Buckalew does.

19  
20 *On page 6 of his testimony Mr. Buckalew continues his discussion of market power*  
21 *and claims that firms with market power will price services "above reasonable levels"*  
22 *and "above marginal cost" (Buckalew Direct page 6). Are the claims correct and, if so,*  
23 *are they cause for concern?*

1 To begin with, Mr. Buckalew provides no clue as to what he considers a “reasonable  
2 level” or how he defines the word “reasonable” so it is difficult to address that issue. But  
3 his reference to pricing at marginal cost is particularly inappropriate because it ignores  
4 several important economic facts that are incontrovertible. First, when a firm operates  
5 with a technology that exhibits increasing returns to scale—as telecommunications firms  
6 do—prices could *never* be set equal to marginal cost because marginal cost is below  
7 average cost and the firm would never cover its total costs nor would it ever operate at a  
8 profit. In this case, a price equal to marginal cost is a most *unreasonable* price for a firm  
9 to charge.

10  
11 Second, when firms are multi-product firms—as all telecommunications firms are—all of  
12 the firms’ products must be sold at prices that enable the firm to recover its joint and  
13 common costs. If a firm sets the price for any single service at marginal cost this forces  
14 the firm to price another service (or all of its other services) in such a way as to recover  
15 the share of joint/common costs that are not being recovered by the first service. If every  
16 service was priced at its marginal cost, again, the firm could not operate at a profit nor  
17 could it even cover its total costs.

18  
19 Third, in a market where products are differentiated even to the slightest degree, prices do  
20 not tend to marginal costs in the face of competition but rather to average costs. As Mr.  
21 Buckalew mentions, it is in perfectly competitive markets that prices will be set at  
22 marginal costs. But in a perfectly competitive market no customer makes a purchase  
23 decision based on anything except price. If any other factor enters into the purchase



1 decision, the market is not perfectly competitive and prices are not set at marginal costs.

2 That is why, as I stated in my direct testimony, perfectly competitive markets are not  
3 found in the real world.

4  
5 **MR. GREG DARNELL**

6  
7 *Q. On page 5 of his testimony Mr. Darnell writes that the Commission does not need to*  
8 *define the phrase “abuse of market position” at this time. Do you agree?*

9  
10 A. No. I believe that the Commission should use this current proceeding to, at a  
11 minimum, establish some guidelines as to what type of behavior constitutes an abuse of  
12 market position. If not, the Commission may find itself in the uncomfortable position of  
13 having to adopt a “We’ll-know-it-when-we-see-it” approach. And while such an  
14 approach does allow for a certain amount of flexibility, it actually does not serve either  
15 firms or customers well. Theoretically, any action that a firm might undertake in an  
16 honest attempt to win customers, seek profits or gain market share—all of which are  
17 acceptable behavior and all of which are pro-competitive and pro-consumer—could be  
18 brought before the Commission as a potential “abuse of market position.” In order to add  
19 clarity to the regulatory process, as well as to help avoid unnecessary (and costly)  
20 regulatory activity, guidelines are needed.

21  
22 *Q. What type of guidelines would you envision coming out of this proceeding?*  
23

1 A. First, because the statute at issue specifically addresses setting rates, the guidelines  
2 must be limited to pricing behavior. (This eliminates issues such as advertising that Dr.  
3 Spearman raised in his direct testimony.) As stated in my direct testimony, pricing  
4 behavior that is clearly anticompetitive, such as lowering prices below costs in an attempt  
5 to engage in predatory pricing, could rightly be considered an attempt to abuse market  
6 position. Establishing appropriate price floors is one way to head-off this type of abuse  
7 of market position.

8  
9 But moving prices in the opposite direction—upward—is clearly not anticompetitive  
10 behavior, because it provides competitors with more incentive to enter a market and more  
11 margin on which to compete once they do enter. Again, as stated in my direct testimony,  
12 the only time upward price movements could possibly be considered a form of abuse of  
13 market power (and an abuse of market position) is when the market is totally closed to  
14 competitors, and there are no acceptable substitutes. Notice there is an important  
15 difference between a market that *has no competitors* and a market that is *closed to*  
16 *competitors*. It is the second condition that is necessary for a firm to behave in a way that  
17 might be considered an abuse of market position.

18  
19 These pricing behaviors should form the guidelines the Commission should turn to in  
20 evaluating potential abuses of market position. Clearly, individual circumstances will  
21 need to be evaluated on a case-by-case basis, so in that sense I agree with the parties  
22 advocating such an approach. But case-by-case evaluation should take place based on  
23 established guidelines.



1 DR WILLIAM TAYLOR

2  
3 *Q. On the tenth page of Dr. Taylor's testimony he writes that the "exercise of market*  
4 *power is not considered an "abuse" of anything" (Taylor Direct, page 10). Yet in your*  
5 *direct testimony (pages 9-10) you provide an example of an unregulated monopolist,*  
6 *facing neither competition nor the threat of competition, that restricts output and*  
7 *exercises its market power and you say that "such behavior could be considered an*  
8 *abuse of market power" (Staihr Direct page 9). Do you disagree with Dr. Taylor's*  
9 *statement?*

10  
11 A. Not at all. The difference lies in the interpretation of the word *abuse* and who is  
12 doing the *considering* that Dr. Taylor mentions. If we define abuse as "to use wrongly or  
13 improperly" then to abuse market power would be to use market power wrongly or  
14 improperly.<sup>2</sup> For a normal profit-seeking firm this is almost an oxymoron, because the  
15 only way to "use market power improperly" would be to not use it at all! (Imagine a  
16 hypothetical CEO addressing his/her shareholders and explaining why the firm chose not  
17 to use its market power: "*We have successfully differentiated our product, our customers*  
18 *are happy to pay a slightly higher price than our competitors charge, but we chose not to*  
19 *take advantage of this increased revenue stream because to do so would be to exercise*  
20 *market power.*" It is doubtful the CEO would remain a CEO for very long.)

21  
22 From an economic standpoint the exercise of market power is not an abuse of anything,  
23 and Dr. Taylor is exactly correct. But in some cases the exercise of market power could

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<sup>2</sup> Second College Edition, The American Heritage Dictionary

1 produce an outcome that is inconsistent with other goals, perhaps social welfare goals. In  
 2 those cases the exercise of market power could produce a result that is undesirable for  
 3 some entity. And that entity would consider the firm's actions an improper use—or an  
 4 abuse—of market power.

5  
 6 ***Q. Do you have a very simple example of the situation you have just described?***

7  
 8 A. Certainly. If an inventor obtains a patent on his invention, the patent often offers the  
 9 inventor a certain degree of market power—since no one else can replicate the invention,  
 10 the inventor can restrict output and charge prices above competitive levels until such time  
 11 as substitutes are available. This type of market power is considered reasonable reward  
 12 for the inventor's efforts. But there might be a group of would-be consumers who cannot  
 13 afford the higher price. They might view the inventor's behavior as a misuse—or an  
 14 abuse—of market power, since the outcome is undesirable for them. There is no question  
 15 that the inventor's actions are an *exercise* of market power (in fact, they are an exercise  
 16 of market power that is guarded by the intellectual property laws in this country). But if  
 17 the invention was something with significant welfare implications—for example, a new  
 18 cancer drug or a promising AIDS vaccine—it is easy to see how this exercise of market  
 19 power could be characterized by some people as an abuse of market power. In such  
 20 cases, the economic arguments are often outweighed by political and social  
 21 considerations.



1 However, it is important to note two things. First, the situation described above requires  
2 a closed market, and the absence of acceptable substitutes. As discussed in my direct  
3 testimony (and Dr. Taylor's testimony as well (Taylor Direct pages 14-15)) this is not the  
4 situation we see in the market for telecommunications services in South Carolina.

5  
6 Second, it is almost unfair to categorize this type of behavior as an "abuse" of market  
7 power (or market position) because it really is simply a case of market power creating,  
8 for some parties, an undesirable outcome. The firm is not acting in an anti-competitive  
9 manner. It is simply doing what firms are supposed to do. Although some parties would  
10 obviously describe this behavior as "abusing market power" a more accurate description  
11 would be to categorize such behavior as "the exercising of market power in a way that  
12 produces a result that is contrary to some other political or social goal."

13  
14 **MR. DENNIS TRIMBLE**

15  
16 *Q. On the twelfth page of Mr. Trimble's testimony he states that he does not believe*  
17 *that the proposed definition of "abuse of market position" should be amended to*  
18 *incorporate "abuse of market power" concerns (Trimble Direct page 12). But in your*  
19 *direct testimony on page four you state that one way a firm might abuse its market*  
20 *position is to abuse market power, which suggests that one definition does incorporate*  
21 *the other. Do you disagree with Mr. Trimble's suggestion?*

1 A. No. In fact, Mr. Trimble and I appear to be in strong agreement. Mr. Trimble and I  
2 both agree that the market in South Carolina for telecommunications services is open to  
3 new entrants, and that acceptable substitutes exist (Trimble Direct pages 17 and 21,  
4 Staihr Direct pages 14 and 20). We also both agree that this confluence of circumstances  
5 prevents incumbent firms from abusing market power. Mr. Trimble's suggestion that it is  
6 not necessary to incorporate an "abuse of market power" definition into "abuse of market  
7 position" is based, I believe, on the situation that exists today in South Carolina, and on  
8 that point I definitely agree with him. My characterization of "abuse of market power" as  
9 one manifestation of "abuse of market position" is based on my defining the phrase on a  
10 much more general level. That is why the statement in my direct testimony reads, "one  
11 possible way that a firm might "abuse its market position" would be to engage in a  
12 specific behavior that could be characterized as "abusing market power" (Staihr Direct  
13 page 4). I do not believe, nor does the evidence support the notion, that this behavior is  
14 possible in South Carolina's market for telecommunications services.

15  
16 *Q. Does this conclude your rebuttal testimony?*

17  
18 A. Yes it does.  
19  
20  
21  
22  
23